



June 27th 2016

Are we seeing the legitimization of mob rule in the UK? Rebellious elites and uneducated ally to proclaim “Age of ignorance”!

EU tells Cameron – “We do not want to be just friends - Get your stuff out of my apartment”! - Fasten your seat belt – we paraphrase immortal Lenny Bruce – non-sked global economy flies again! – Will stiff upper lip last? – Scared to death of “Shadow Banking”!

Markets have not yet begun to shake out, stay hedged! – Leave campaign some want to “control” immigration – what about the others? – Not wild about EM – Last one to leave turn off the light!

Week 2 of ARE – After Referendum ERA!

We are entering the second week of the ARE – After Referendum Era and the world-despite collapsing financial markets – is still spinning! Are we being too Euro-centric? We think not! The pound – once the world’s reserve currency – keeps falling and there continues to be havoc on the European stock exchanges.

We expect that we are far from out of the woods and foresee that like an earthquake the initial damage shall be followed by collateral losses triggered by fire and flood.

UK – total confusion!

On the UK front the confusion appears to be total with both the conservatives and labor in complete disarray. We see it as utterly pointless to speculate as to which shall be the final “arrangement” the UK shall choose. There is nobody there to negotiate and the erstwhile EU partners do not appear to be in a conciliatory mood!

Osborne speech unleashes further selling!

As expected the speech by Osborne – the equivalent of the US Treasury secretary – has done little to reassure. The term “adjustment” is being used as a euphemism for recession and – we believe – longer term, slow growth. We are repeatedly told that the UK is only 4 per cent of global GDP.

This is a rubbish argument – Lehman Brother counted for much less and we are still dressing our wounds today. Commercial and financial interconnections in the context of integrated economies count for far more.

Banking stocks kaput!

These points have not been lost on owners of banking stocks. Barclays and RBS had trading in their shares halted as investors make a dash for the door! To regulation, slow global growth, low interest rates has now been added utter uncertainty as to whether they shall be able to still access EU markets.

Italy wants a waiver!

In Italy, prior to “The Vote” seen as the epicenter of the banking crisis, the government wants EU rules on direct state assistance to the banking system waived. We are not surprised. The private sector scheme via the Atlas backstop was already floundering and the UK vote was an excellent opportunity to push through the request.

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The message is simple. Either the EU agrees or we shall have another locus of major banking turmoil. This is not what the EU wants now.

It all started with a fight among friends!

On the political front this week shall see the beginning of EU meetings without the UK. We can well understand the anger of the other members – whose economies and people shall pay a steep price for the conservative party's ill-fated attempt to overtake the United Kingdom Independence Party on the right.

Emotional “victory lap” Leave campaign not yet over!

Kerry is on the way to Europe to seek clarity. We wish him luck! This is a – hopefully – first and one of a kind event. What is being lost on many observers is that this event was not the result of sound economic reasoning but of a need to reaffirm sovereignty. The “victory lap” has yet to run its course – cooler heads and organization are not the order of the day!

We are seeing a continued move towards the safe havens, which we expect to accelerate. Credit risk in Europe is – finally – being repriced. Will there be profits to be made selling overpriced protection on fundamentally strong companies?

Be grateful for small mercies – center holds in Spain!

The one good piece of news is the strong showing of the PP and Rajoy in the Spanish elections. Prospects of a wide fall-out from the UK have tempered people's penchant for embarking on radical adventures. That said the anti – EU far left has held, while the more moderate socialists have lost seats. Is this the spring being coiled for an advance next time?

1-Summary of the plot! Young, charming UK prime minister goes “A vote too far” and drives off cliff! Global economy now at mercy of 100 people arguing in London! Scary!

Does the UK's conservative party have a talent for self-destruction?

We may well ask whether the UK government has not unwittingly engineered an “internal Suez crisis”. In 1956 the vestiges of a dying colonialism triggered the biggest UK foreign policy debacle - cementing the country's steady political decline.

Attacking Egypt - a struggling third world country fighting neo-colonialist aggression - did not go down well in the post-war world!

Cannot believe that this debacle started with a quarrel among chums!

Last week the ineptness of a prime minister seeking to win a spat within the conservative party has unleashed a reaction which shall take years to run its course. Like the Arab Spring which was seen as heralding freedom but has engendered chaos, we see last week's events as the prelude to massive shifts in the political and economic construct.

New school of economic thought – makes import substitution look enlightened!



*A prospective secession based on a “Biggles – Commonwealth” view of the global economy risks breaking up the world’s largest trading bloc and ushering in “The era of economic obscurantism”.
Some are making comparisons to the UK’s exit from the EMS in 1992.*

Leaving EU is not like leaving EMS!

We see the comparison as spurious for two reasons:

The UK stayed in the EU, along with Italy.

The global interconnections at the economic and financial level were less developed minimizing the impact.

We see this as a defining moment for the global world economic and political order – confirming the grim view that history is not unidirectional.

2 - Fasten your seat belt!

Expect markets to come under further pressure – this is a start and not an end!

Markets are continuing to get their arms around the “sea change” wrought by the – for some – surprising result of the UK-EU vote. We do not share the enthusiasm of some who see this as a short term re-pricing. We beg to differ and reiterate our view that we have not yet seen the whites of their eyes!

It seems to be getting “lost in translation” that we are dealing with the European Union’s second largest economy and one of the world’s major beneficiaries of foreign direct investment.

Too early to discuss future model – still in the early stabilization phase.

Discussions as to which model should be adopted – post EU exit – are senseless until there is a government in place able to open negotiations. The UK has been served a “get your stuff out of my apartment” notice! We are seeing a hardening of the tone with scarce willingness to grant “most favored nation” status without politically impossible labor mobility.

3- Central banks to the rescue?

Central banks shall provide liquidity to banks – we expect widening spreads across a wide range of assets

Stiff upper lip admirable but not sufficient!

Stiff upper lip appears to be the “word of order” for global central banks. The Bank of England informs that there is nothing to worry about as the UK banks are bursting with health. Should financing be required 250 billion pounds are ready! This does not explain why the top UK lenders collapsed more than 20 per cent!

Central banks issuing “comfort letters” – very hard to enforce!

We are seeing similar “comfort letters” of the type - issued by parent companies of subsidiaries veering on collapse – from the ECB and others. While we do not doubt their sincerity, it is a sorry reflection that eight years on and endless liquidity and capital injections, we are still fretting about the health of the banks!

4 – The UK Banking System



We are not finished with the banking system!

UK bank privatizations put on hold – will more money shall be necessary?

The UK government shall now need to postpone once again the sale of RBS and Lloyds Bank – the result of the financial crisis and the state as banker! With a UK recession on the cards and falling government revenue, where shall the money come from for a further re-capitalization?

What about the “Shadow Banking” system? - UK adopting specialized lender “Countrywide” model

But are we barking up the wrong tree? Should we not be focusing on the “shadow banking” system which has stepped into the breach for the traditional commercial banks? The non-bank lenders in the UK appear to have cloned the “Countrywide” model much beloved in the US prior to the financial crisis.

Will the Bank of England be forced to once again bail-out the irresponsible?

A massive exposure to the riskier fringes of property lending and limited funding flexibility do not bode well! We expect a bloodbath in UK property with non-diversified lenders taking it on the snout. Will the Bank of England be forced to bail them out? What shall be the political consequences?

5- “The immigrant question”

Will this turn into harassment of children of immigrants in the UK?

Starting to see backtracking from the instigators of a campaign based on ultimately appealing to fears of “The other”

Moving on to the key issue – the primacy of politics- we are seeing substantial confusion as to the future UK leadership. We are seeing backtracking from the “secessionists” with regard to some of the key promises made during the campaign.

Some want to “control” immigration others will close the door!

The key issue is immigration which was the battle horse of the leave campaign. We are starting to see a subdivision within the “go it alone” camp between “revisionists” and “Stalinists”. The former wish to control the flow of new-comers while the latter shall not shrink from closing the doors!

We are already reading of increased hostility towards immigrants. The “Leave” campaign may have opened a Pandora’s Box which they shall find very difficult to close. This could get very ugly.

6 – Are we seeing the end of Yugoslavia?

EU stalwarts running scared!

European Union in a state of shock – Socialist French president meets with leader of National Front!



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Turning abroad – we are seeing shocked reactions throughout the European Union. The fear of a spread of “referendum-itis” and direct democracy – at which the retrograde are expert – has forced the French socialist president to meet with the head of the National Front!

We are keeping a close watch on Spain – expect progress of extreme left

Today’s Spanish elections may also prove to be another “body blow” to those who believe in growing economic and political cooperation. Should the anti- everything Podemos and hard left alliance succeed in emerging as the second largest party - European investor nervousness may well ratchet higher.

Do not see a US Civil War type secession sequence in the continental EU

*Will there be a spate of departures from the EU? We see this as the lesser evil due to:
The relatively long term time frame
The greater interdependence of the “continental” EU countries as compared to the UK.*

Who shrunk the UK?

Greater danger break-up of the UK

We view as the greater short term risk a breaking up of the UK. Scotland is wasting no time in getting into the starting blocks for another go and Northern Ireland shall likely follow. The breaking up of the second EU economy shall not be seen favorably by the capital markets, raising financing costs at both the sovereign and corporate level.

What was striking is that the referendum highlighted a state not only segmented by age and education but also by geography. England voted out – while Scotland was overwhelmingly pro-EU.

7- Federal Reserve and the ECB – can they play doubles?

Is the Federal Reserve walking on eggs?

As concerns monetary policy, we reiterate our view that the Federal Reserve shall tread cautiously. This shall be driven by two major factors:

1-The fear of causing “mass of money” shifts from the emerging markets with second round effects being:

A re-leveraging of US Dollar mismatched liabilities

Difficulties in attracting financial flows to cover current account deficits without needing to increase interest rates.

2-The second driver focuses on concerns that a fragile US recovery may be thrown off course by a further drop in capital spending as companies make a further dash for cash.

ECB – two strategies- short – short term and short term!

ECB shall be operating on a dual axis - monetary measures and lender of last resort

We see the European Central Bank as acting on a dual axis:

Monetary easing and bond buying to lift inflation via currency devaluation

Providing liquidity to the banking system and – where necessary – foreign exchange.

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We expect further turbulence in the European banking sector and see little scope for a revival of the equity markets prior to a stabilization of the financial sector.

8- Expect further weakness in EM – looking for PE ratios of 6!

Cautious on emerging markets – do not buy inflation story

We remain cautious as to the emerging markets with caution by the US central bank outweighed by the risk of slowing global growth. Some analysts are foreseeing sharp increases in inflation in some economies – for example – Brazil as the currency depreciation pushes up import prices. We do not agree and see Brazil as:

1- A “closed” economy

2- Having sharply reduced imports

The key point is that the Brazilian problem and solution are overwhelmingly internal.

Not wild about Japan

This is not about Japan!

Will we see Japan pass from stagnation to collapse? We see the Japanese economy as slow at best. While safe haven flows into the yen shall reduce export competitiveness – a strong currency has not impeded exports from accounting for close to 50 per cent of exports. Japan’s problems are structural and not solvable via either FX devaluations or short term fiscal policy.

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